The bond fund with equity-like returns

When Christian Baylis left UBS' fixed income team to set up Fortlake Asset Management in December 2020, the bond market was in a dire place.

As the pandemic raged, borders were closed while central banks flooded the world with cash. With Australian interest rates already near zero, the Reserve Bank's Phil Lowe began buying billions of dollars bonds, further squeezing returns. The threat of inflation: non-existent.

"We started the fund in a very low inflation environment, before it was a taxi driver topic," Baylis tells *The Australian Financial Review.*

Now, three years on, inflation is an all-pervasive force – driving household budgets and financial markets as central banks have been forced into a dramatic response.

"Interest rates had to go up, and in hindsight that's very obvious when interest rates are at zero."

That's precisely how Baylis likes it. In the year to June 30, 2023, Fortlake, which manages around $600 million of assets, has delivered 20 per cent plus gains based in part on bets that inflation rates would surge. Those outcomes are more equity-like than bond-like, where most fixed-income funds delivered gains of around 4 per cent.

"We're not out there saying we're a garden variety fixed income manager. We're an absolute return manager, and we will go where the returns take us," Baylis says.

The bond market, he says, is multidimensional, providing a range of trading opportunities for those that know how to navigate it.

"We use the fixed income universe, not to be a fixed income investor, but as a conduit for returns."

Volatility shifts to credit markets

Baylis says standard fixed-income funds might have correctly anticipated that inflation would rise, but if they bought inflation-linked bonds they wouldn't have made money, because rising interest rates would have offset the profits from higher inflation rates.

Instead, Fortlake made money through buying options tied to the inflation rate – in which the downside was capped, but the pay-out was potentially large as consumer price index measures exploded.

“You’re seeing huge amounts of volatility in the risk-free part of the market, and you’re getting really good returns in government bonds for the first time in a very long time.

“Whereas in the credit market, you’re getting really-poor risk-adjusted returns. You’ve had a really bullish credit period and there are huge amounts of complacency in credit,” he adds.

In other words, Fortlake believes that inflation and interest rate markets will be calmer relative to the volatility implied in market pricing. Meanwhile, orderly corporate markets could be more chaotic as companies hit the wall. That’s where the trading opportunity will be.

Bayliss has a PhD in econometrics. His career in finance – including credit rating agency Standard & Poor’s, the Reserve Bank and UBS Global Asset Management – equipped him with the skills to invest across the entire fixed income market.

“It’s like being a builder, a carpenter, a plumber, a fitter and now a business owner, taking all the relevant experience accumulated from all these places,” Baylis said.

He set up Fortlake with the backing of billionaire investor Alex Waislitz in the middle of the pandemic.

Understanding, forecasting and trading inflation has been the ideal skill to have over the past three years as markets and central banks have battled to come to terms with rising prices in the aftermath of COVID-19.

“The inflation process starts with particularly workers asking for compensation for past inflation, then asking for present inflation and then asking for future compensation that they know is coming down the pipe,” says Baylis.

Now, he says, we’re in the final stages of that process as workers look to get ahead of expected inflation.

In his view, the Reserve Bank underestimated the inflationary threat and was misguided in believing that the offshore experience of rapid wage growth would not occur to the same extent in Australia.

He says Australia’s high minimum wage and enterprise bargaining agreements created a false perception that businesses would avoid paying the global price of labour.

A political pile-on

However, Baylis does have sympathies for the Reserve Bank and its governor Philip Lowe, whose term wasn’t renewed.

Lowe admitted he got his forecasts wrong when he steadfastly pushed back against market signals that told him he’d have to lift interest rates sooner than he’d told the Australian public.

“He’s an incredibly humble, non-egotistical type of guy and that hasn’t served him well. Unfortunately, if you admit your faults in this day and age you get a political pile-on, and you get people out to take you down.”

But Baylis is also of the view that the Reserve Bank really should have “adjusted its communication” to reflect that uncertainty in an unprecedented post-pandemic period rather than stick to the script that rates weren’t going up.

“A volatile uncertain world is not a world to double down on surety, and on giving people more confidence. If you’re a company executive, and you’ve gone through a difficult and volatile trading period, you’d be loath to give guidance.”

He says central banks that have enacted hard and fast interest rate rises did the right thing. Once the extent of the inflationary threat emerged, monetary policy turned to “risk mitigation”.

“The objective should be, in my view, to get the cash rate about the inflation rate as quickly as possible. And then preferably start to bring it down. But the bigger risk is going too slow for too long.”

Baylis is not convinced the RBA will be able to preserve record low unemployment and also slay inflation by easing off on rate rises.

It’s a case of the RBA wanting to “have their cake and eat it” and that approach, he says, is not shared by other central banks.

“We’re an inflation targeting central bank, and we have to, unfortunately, pick one goal and nail it.”

So, where do we go from here?

There is renewed enthusiasm in financial markets that peak interest rates are in sight. That’s been the case in Australia, but strong jobs data has led local bond traders to reconsider the possibility of two more rate rises, rather than one, from the current 4.1 per cent setting.

Baylis says it will depend on the inflation data, but leans toward more interest rate rises ahead.

“I cannot believe that if we’re sitting here with core inflation around 5 per cent and the cash rate at 4.1 per cent that we can sit here with a straight face and say we’ve got restrictive policy.”

What he is convinced about is that the era of low inflation is over, and investors will have to adjust their mindsets and expectations to beat it.

“When inflation was at 1 or 2 per cent you could brush it aside. At 7 per cent, you have to think of inflation-linked strategies.”

“It’s like rocking up to the start line and giving people a 6.8 per cent head start. You are at a huge negative handicap.”

“That is the number one problem you have to solve as an allocator – how do I offset this cancerous problem of inflation? And unfortunately, that’s applicable to households as well.”

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